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ABSTRACT

The application of professional judgment in reviewing and, if necessary, adjusting the results of need analyses in student financial aid is discussed. Specifically, guidelines and alternatives are provided that may be exercised in determining a family's reasonable ability to provide for postsecondary educational expenses. The following topics are discussed: the purpose of need analysis budgets, financial need calculations, situations requiring professional judgment); deciding whether adjustments are needed (documentation and tools, including need analysis and income tax returns); reviewing data used in need analysis (personal data, dependency, demographics, expectation of family support, parents' information and income, allowances against income, parents' assets, parents' contribution, dependent students' income and assets); independent students (taxable income, estimated income, untaxed income and benefits, and assets); and children of divorced or separated parents (calculating the family contribution, alimony and child support). Contains 17 references. (KM)

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PROFESSIONAL JUDGMENT IN NEED ANALYSIS

NASFAA MONOGRAPH SERIES
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PROFESSIONAL JUDGMENT
IN
NEED ANALYSIS

Prepared by the NASFAA
Need Analysis Standards Committee

National Association of
Student Financial Aid Administrators

Washington, D.C.
October 1987

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Preface

For over thirty years, aid administrators and others have debated the nature and structure of need analysis. As now practiced, need analysis is based on commonly accepted definitions and basic principles of economics. Beyond the fundamentals of need analysis, there has also developed expertise about exercising professional judgment in reviewing and, if necessary, adjusting the results of need analysis. This expertise about discretionary decisions has been shared formally in organized meetings and informally in day to day conversations.

The 1978-79 NASFAA Committee on Need Analysis and Delivery recognized the need to compile and distill this information in a publication that would benefit both experienced and inexperienced aid professionals. They began the task of developing a document on professional judgment. Through the efforts of that committee and the later work of the 1982-83 Need Analysis Standards Committee (in particular, Chairperson Larry Dietz, and Edward Franziem of the Vermont Student Assistance Corporation) the first edition of this publication, Special Report #5, was issued in May 1983. Changes in standard need analysis practices for 1984-85 necessitated a revised and expanded edition, issued as Special Report #10 in December 1984.

In a continuing effort to assist financial aid administrators in the area of professional judgment, it is the intent of the Need Analysis Standards Committee to update this publication whenever changes in need analysis procedures may warrant a new edition. The present revision, which was prepared by Joe Paul Case, is occasioned by the 1986 reauthorization of the Higher Education Act and by the Tax Reform Act of 1986.

As with the original Special Report on professional judgment, it is not the intent of this publication to be all-inclusive, but to provide financial aid administrators with guidelines or suggested alternatives that may be exercised in determining a family's reasonable ability to provide for postsecondary educational expenses.

The members of the 1986-87 Need Analysis Standards Committee assisted in the development and review of this publication. The committee members were:

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The Need Analysis Standards Committee encourages the membership of NASFAA and other interested individuals to comment on this monograph.

PROFESSIONAL JUDGMENT IN NEED ANALYSIS

Introduction

The purpose of need analysis

The purpose of need analysis is to assess a family's financial resources to determine a reasonable amount that can be expected to be provided to help meet the cost of postsecondary education. A uniform set of criteria is used to make this assessment in need analysis. Although the criteria may appropriately be applied to a wide variety of family situations, there are cases in which strict adherence to the criteria may not be appropriate. Deciding whether the standard procedures apply to a given case is left to the discretion of the financial aid administrator.

Standard need analysis procedures

Since the establishment of a broadly used scheme of need analysis in the early 1950s, the system has been modified from time to time to provide a systematic approach to measuring family ability to pay for college. Beginning in 1975 the need analysis system most widely used was the Uniform Methodology, which was a product of the National Task Force on Student Aid Problems. Most (but not all) aspects of the Uniform Methodology have been embodied in the need analysis provisions of the 1986 amendments to the Higher Education Act.

In need analysis, the aid administrator uniformly applies the same objective standards to all applicants, while taking into account in individual cases circumstances that may affect the relative financial strength of a family. The need analysis system is designed to accommodate obligatory expenses, such as taxes, as well as typical family living costs. In many instances, even unusual expenses, such as excessive medical or dental costs, are addressed by special provisions of the need analysis methodology. Nevertheless, in other cases, the financial strength of a family cannot be portrayed accurately by using the standard procedures. Because each family's situation is unique, extraordinary circumstances occasionally will arise that require individual attention. In these cases, the aid administrator is expected to weigh the family's situation both objectively and subjectively in order to render a professional judgment about the financial support that the family can reasonably provide toward the applicant's postsecondary expenses. Professional judgment represents a key factor in the student financial aid delivery system -- the capacity for personal intervention by the aid administrator in cases that merit individual attention.

An understanding of the basic principles of need analysis is essential to the aid administrator's review of any case. Among these tenets are the following:

- For dependent students, both the student and parents share the obligation to contribute toward educational expenses.

- For independent students, it is expected that a major part of the student's income and assets will be allocated to the student's educational costs as well as the family's living expenses.

- Families are considered equitably in relation to one another -- that is, there is "horizontal equity" among families in similar situations and "vertical equity" among those in dissimilar situations.

- The analysis of a family's situation is an objective assessment of its present circumstances; it does not make assumptions or prejudge the nature of their situation.

- Progressive assessment rates are used to calculate the family contribution so that those with greater resources have a larger proportion of those resources deemed available for educational expenses than those of more modest means.

- Need analysis procedures recognize that part of family resources must be devoted to taxes, basic living costs, and other unavoidable expenses; other expenditures that are a matter of family choice are usually not included as allowances against available income or discretionary net worth.

The latter point is an important element of professional judgment in need analysis. That is, the aid administrator should be able to distinguish between changes in a family's circumstances that are a function of choice, and those that are a function of necessity. Using this distinction in expenses will help the aid administrator make better decisions about a given family's circumstances.

Appropriate student expense budgets

Determination of a family's ability to pay for educational expenses is but one part of need analysis. Equally significant is the construction of a realistic student expense budget. Some situations may call for an adjustment on the budget side of the need equation instead of on the side of calculating a family contribution. For example, allowances for unusually high transportation costs may appropriately be reflected in an adjustment to the expense budget rather than as a change in the expected family contribution.

Adjustments in calculation of financial need

Adjustments in need analysis -- whether in the student expense budget or the determination of family contribution -- may result in either an increase or decrease in the student's need. If the aid administrator is satisfied that the adjustment is based on verifiable information and may be justified as reasonable on grounds of professional judgment, the resulting need figure should be valid for all forms of aid, regardless of source.

In regard to federal campus-based financial aid programs and the Guaranteed Student Loan program, the aid administrator should note that through academic year 1987-88 procedures used in need analysis must conform with one of the systems approved by the United States Department of Education. Beginning in 1988-89 the need analysis procedures specified in Part F of Title IV of the Higher Education Act, as revised in 1986 and amended in 1987, will be used in determining need for federal funds. Both current regulations and law recognize, however, that adjustments may be made in need analysis. Indeed, the Higher Education Act provides that discretionary judgments may be employed. Section 479A(a) states:

> Nothing in [Title IV] shall be interpreted as limiting the authority of the student financial aid administrator, on the basis of adequate documentation, to make necessary adjustments to the cost of attendance and expected family contribution (or both) to allow for treatment of individual students with special circumstances. In addition, nothing in this title shall be interpreted as limiting the authority of the student financial aid administrator to use supplementary information about the

> financial status or personal circumstance of eligible applicants in selecting recipients and determining the amounts of awards under [the Pell Grant, Supplemental Educational Opportunity Grant, College Work-Study, Perkins Loan, or Guaranteed Student Loan programs].

For the Pell Grant Program, beginning with the 1988-89 award year, the aid administrator has authority to make revisions as noted above. If a revision is made to data elements, the computation procedure, or end result of need analysis under Part F of Title IV, the expectation is that a corresponding revision will also be made in determining the Student Aid Index for the Pell Grant Program, as set forth in Subpart 1 of Part A.

Situations requiring professional judgment

This publication identifies a variety of situations in which it may be appropriate to use professional judgment. Alternatives are suggested to assist aid administrators in assessing more sensitively the ability of a family to pay for postsecondary education. The intent is to be descriptive, not prescriptive, of alternate ways of considering particular circumstances. Not all aid administrators will agree with every adjustment described. Instead, it is hoped that this publication will provide a foundation on which good practice and consistent treatment of aid applicants can be developed.

Deciding whether adjustments are needed

Basis for changes

An examination of the student's application and need analysis documents is usually the first step in deciding whether the calculated family contribution is appropriate to the student's situation. In many cases this review will not reveal any reason for an adjustment to be made or additional information or clarification to be sought. If this is the case, the aid administrator may proceed with construction of the student expense budget, calculation of need, and packaging of financial aid. In other cases, however, it may be necessary to obtain information in addition to that found on the application, need analysis documents, or other materials already submitted by the student.

Documentation

If the aid administrator determines that the need analysis should be changed, the reasons for the revision should be sufficiently documented in the student's record so that any aid awarded as a result of the change can be explained in an audit or program review. The documentation will also provide a history of the applicant's circumstances as a reference for the future. It may be helpful to compile a record of exceptions so that institutional policies regarding professional judgment may be developed as the basis for consistent treatment of other aid applicants with similar circumstances. There are no standard guidelines for documentation; however, sufficient notes should be made so that another aid administrator reviewing the student's case could easily ascertain the reason any changes were made as well as their effect on the need analysis and aid package. The source of information, name of the aid administrator making the adjustment, and date should also be recorded.

Distinction from verification

Making a professional judgment sometimes involves the collection and interpretation of additional information from the family. In this sense, professional judgment should not be confused with efforts to verify information provided by the family, although in some instances it may be difficult to separate these issues, particularly if the extra information suggests a need for follow-up in related or additional areas.

Tools used in review

The aid administrator has available a number of tools that can help in reviewing a student's file. These may include an institutional aid application, need analysis forms and reports, income tax returns, and other documents obtained from the student and his or her family to substantiate the information on which the need analysis is based. Need analysis documents contain the basic data used to calculate the family contribution and determine financial need. The nature and consistency of the information reported by the family may indicate whether an adjustment is needed or additional information should be requested.

Institutional aid applications. Relevant additional information may be recorded on an institutional application form. This may include biographical and financial data and information about the family situation. There may be unusual circumstances that affect the family's ability to meet college expenses. Such information may assist the aid administrator in reviewing the need analysis and in making adjustments to the assessment of a family's ability to pay.

Need analysis documents. The national need analysis services prepare reports that provide the details of need analysis. The reports may also contain messages to assist the aid administrator in interpreting the information reported by the family. Other messages may relate to the verification requirements of the United States Department of Education. Some messages may note assumptions made by the national service in developing the need analysis or highlight items that may need review of the aid administrator because of apparent inconsistencies. By referring to these messages the aid administrator may decide to follow up on relevant data elements in the need analysis documents and, if necessary, make adjustments in the analysis.

Income tax returns. Many institutions now require that their aid applicants submit copies of income tax returns to substantiate the information reported in need analysis documents. The instructions for the standard forms published by the national services contain numerous references to the individual income tax return (IRS Form 1040, 1040A, or 1040EZ) and to supplementary schedules that may be submitted with Form 1040 (for example, Schedule A for itemized deductions, and Schedule B for interest and dividend income). Income tax forms may be especially useful in interpreting more complex family situations, especially when income is derived from sources other than wages or salaries from employment. In instances of students from families that own a substantial part of a corporation or partnership, some aid administrators also ask that copies of corporate or partnership tax returns be submitted for review.

Other documentation. It is important to recognize that income tax returns do have limitations in the review process. Tax returns do not enable the aid administrator to check all the items that are taken into account in ability to pay. In some instances, the aid administrator may want to obtain additional documentation from the family to substantiate other data appearing in need analysis materials. These data might include:

- Untaxed income and benefits -- social security and other retirement and survivors' benefits, veterans' benefits, welfare payments, interest income from tax-exempt securities, housing and subsistence allowances, gifts, inheritances, bequests, and so forth.

- Asset holdings -- value of home and other real estate, outstanding mortgage balances, cash, savings, and checking accounts, investments, and business and farm assets and indebtedness.

- Parents' or student's marital status, including additional information in divorced or separated situations, such as alimony and child support payments, arrangements for paying college costs, and so forth.

- Number of family members, number in college, and elementary and secondary school costs.

Reviewing Data Used in Need Analysis

Numerous aspects of need analysis may be explored. The following sections describe procedures that some aid administrators use in reviewing the data used in need analysis.

Personal data

The review of a student's application should begin with an examination of the demographic information provided to get an orientation to the case.

Dependency

A major question in considering a student's financial need is whether the parents' financial information is to be considered in need analysis. Federal guidelines for dependency status were established by the Higher Education Act and appear on the application forms of the national need analysis services. The federal definition was revised for the 1987-88 academic year (and as of January 1, 1987, for the Guaranteed Student Loan Program). Under the definition, a student is considered independent:

- If he or she:
  - is 24 years of age by December 31 of the award year; or
  - is an orphan or a ward of the court; or
  - is a veteran of the United States armed forces; or
  - has legal dependents other than a spouse.
- If the student is an unmarried undergraduate, he or she may be considered independent:
  - if the student's parents (or guardian) did not claim the student as a dependent for income tax purposes for the two calendar years preceding the award year; and
  - if the student can demonstrate an annual total resources (excluding aid from parents) of $4,000 or more in the two calendar years prior to the initial receipt of Title IV aid, beginning with the 1987-88 award year.
- If the applicant is married or a graduate or professional student, he or she may be considered independent:
  - if the student's parents will not claim the student as a dependent for income tax purposes for the first calendar year of the award year.

(In regard either to unmarried undergraduates or to married students or graduate or professional students, the aid administrator must document the student's status before federal funds may be disbursed. In addition, if the aid administrator subsequently finds that a student in the three categories just mentioned (unmarried undergraduates, married students, or

graduate or professional students) was claimed as a dependent for income tax purposes by another person [except the student's spouse], the student cannot be considered independent, except as provided below.)

- Overriding all of these considerations is the authority of the aid administrator to determine a student to be independent on the basis of documentation of other unusual circumstances.

Obviously the student's responses to the questions establishing dependency status for federal programs may suggest the need to request further documentation from either the student or the parents. Specific guidance regarding documentation is included in a U.S. Department of Education "Dear Colleague" letter, GEN 87-6 (February 1987). Further clarification of the federal definition is provided in later "Dear Colleague" letter, GEN 87-34 (August 1987).

In considering the resources available to an independent student, it may be appropriate to expect a contribution from the student's parents. The conference committee managers of the 1986 bill to reauthorize the Higher Education Act recognized this. In the conference report they observed that:

> [Section 479A of the Higher Education Act] allows the student financial aid administrator to make necessary adjustments to the need analysis computations based on additional knowledge about the financial status of students which they [sic] might have. This includes not only allowing a more liberal financial aid package for some students, but also the ability to restrict aid for students who have additional sources of support not apparent in the analysis. For example, if an aid administrator was aware that a graduate or professional student was receiving support from his or her family, it is the intention of the conferees that the administrator would have the ability to reduce the student's eligibility for Federal assistance accordingly. The conferees are particularly concerned that students from high income families who are enrolled in high cost programs and who would otherwise be considered independent of their parents, be carefully evaluated to determine if a parental contribution is warranted.

Despite the possible expectation of a parents' contribution for an independent student, the aid administrator cannot shift a student from independent to dependent status for federal purposes if the student otherwise meets the requirements of the federal definition of an independent student.

It should be noted that the institution may establish a more restrictive definition for determining independence <u>for institutional aid purposes</u>, although care should be taken to treat students within a given category consistently. If the institution's requirements for independent status are more restrictive, the aid administrator may want to collect additional information from the student and his or her parents, such as parental affidavits, rent receipts, and tax forms. Some factors to consider in making a determination about an applicant's independence are the following:

- The answers to the standard questions regarding student status;
- The student's address as compared to that of the parents;
- The parents' signatures certifying independence;

- The level of financial support from the parents which the student may report;

- Any knowledge the aid administrator has of the relationship between the student and parents;

- The possibility of "alternative parents," especially if the applicant's income in the recent past is such as to make self-support questionable;

- The material presented by the student in support of the application to be considered independent; and

- The student's residence during nonenrollment periods for the preceding two years.

In cases in which there are questions about a student's dependency status, it is appropriate to require documentation, including appropriate tax returns from both the parents and the student, notarized statements, and rent receipts or other supporting evidence of a separate domicile.

Economic straits may cause some otherwise independent students to reside temporarily with their parents. Recently divorced or separated persons, individuals leaving military service, or persons who have recently become unemployed may fall in the group. In such cases, the aid administrator may want to review prior dependency status to determine if the living arrangements are in fact temporary and, if so, exercise professional judgment in the treatment of these students.

Other demographic data

The student's responses to other questions that collect demographic information should also be reviewed. Here is a summary of these data and the areas of need analysis that may be affected if the responses are missing, incomplete, or inaccurate. In some cases a completed or corrected response may necessitate recalculation of the total family contribution.

Student's year in college

- Affected area: student's minimum ("mandatory") contribution. This figure which is different for first-year undergraduates and for other undergraduates as well as graduate and professional students.

Student's marital status

- Affected area: standard maintenance allowance/maintenance allowance for periods of nonenrollment. A standard maintenance allowance is used in need analysis for independent students with dependents, including a spouse. For independent students without dependents, a monthly maintenance allowance is granted for periods of nonenrollment.

- Affected area: employment allowance. For independent students, the employment allowance is based on the lower income from employment of a married couple or the employment income of a single student with dependent children.

- Affected area: asset protection allowance. For independent students, the allowance is based on the student's age and family size. Family size may be affected by a change in marital status.

- Affected area: asset conversion rate. Different conversion rate are used for independent students with dependents (including a spouse) and for independent students without dependents.

- Affected area: total family contribution. Different family contribution assessment rates apply to independent students with dependents versus those without dependents.

Student's number of family members

- Affected area: student's expense budget. The expense budget includes the student's expenses, however, the budget of an independent student may include an allowance for child care costs.

- Affected area: standard maintenance allowance/maintenance allowance for periods of nonenrollment. (Same as above.)

- Affected area: asset protection allowance. (Same as above.)

- Affected area: asset conversion rate. (Same as above.)

- Affected area: total family contribution. (Same as above.)

Student's family members in college

- Affected area: family contribution for student. The total family contribution for an independent student is divided by the number of student's family members in college.

Expectation of family support for the student

In some cases such as disinheritance, parents' refusal to file any information, or other unique circumstances, the student may not meet the usual requirements for independence, but may have no parents' contribution on which to rely. The aid administrator may treat such students as independent if institutional policy permits and judicious review merits such consideration.

Parents' information

Parents' marital status and family size

In most cases the data about parents' marital status and family size are straightforward and there is no ambiguity. In situations in which questions arise, however, it may be necessary to correspond with the student or parents to resolve the matter. If the parents' marital status must be revised, a different asset protection allowance will be used in need analysis. Likewise, if the family size is altered, there will be a change in the standard maintenance allowance.

Exemptions. The number of exemptions claimed on the income tax return is one source for checking the family size. This number will not always agree with family size even if the family size is correct. Through 1987, extra exemptions are granted for persons who are age 65 or older and who are blind. (In 1988 an beyond, higher standard deductions, rather than additional personal exemptions, are provided for elderly and blind persons. No additional allowance is made if they itemize deductions.) In divorced or separated cases the noncustodial parent may claim some or all of the children because child support is provided or because the divorce decree or separation agreements specifies such an arrangement. There may also be differences because of a death or the departure of someone from the household.

Inclusion of older children. Some aid administrators will not count older children who are reported as members of the household unless there is some explanation from the family to justify their inclusion. In general, older children are included if they are handicapped or mentally retarded and require family financial support. In some cases they may be included if they are unemployed and unable to find work. On the other hand, older children are usually excluded if they are fully employed and represent no drain on the family's resources.

Support for other family members. When aid administrators exercise professional judgment with respect to older children, documentation should always be obtained. Similarly, documentation should be obtained when adjustments are made to allow for support of grandparents or other relatives. Such support may include nursing home fees, other medical expenses, or general living costs. Although families frequently neglect to detail these expenses on the financial aid application, the aid administrator should be sensitive to the possibility of such expenses that may affect the family's discretionary income.

Parents' family members in college

For academic years 1984-85 through 1987-88 the parents' contribution was not routinely adjusted to reflect a parent's enrollment in postsecondary education. Beginning again with the 1988-89 academic year, under the need analysis provisions of the Higher Education Act, parents are included in the number in college figure. As of 1988-89, if a parent of a dependent student is enrolled, an adjustment will be made as part of the normal processing procedure.

The financial aid administrator may instead in individual cases elect to exclude the parents from the count of family members in college but recognize their educational costs, especially if the education is expected or required for advancement in employment, retraining, or in other similar circumstances. Expenses to be considered would include tuition, fees, books and supplies as well as commuting and food costs. In this case it would be reasonable to allow unreimbursed direct educational expenses of a parent as an allowance against parents' available income. Otherwise, if the parent is counted in the number of family members in college, it may be appropriate to subtract the parent's educational expenses from the total parents' contribution and divide the remainder among the dependent children who are in college.

Aid administrators may want to confirm the reported number of family members who will be enrolled at least half-time in postsecondary education. Some institutions have the practice of asking students to have the other family members verify their status after the academic year has begun by obtaining a certification of enrollment from the other family members' institutions. It may be useful to examine the attendance costs and financial aid of these family members, as well. If their expenses do not represent a substantial drain on family resources, other family members may be excluded from consideration, at the discretion of the

aid administrator. For example, family members may attend military service academies or be receiving grants or scholarships that cover their entire educational expenses. Special care may be needed in reviewing applications of enrolled single parents who have dependent children also enrolled in college to ensure that reasonable costs are considered while not overlooking aid the dependent child may receive.

Parents' income

Definition of income

The definition of income for need analysis purposes is of prime importance to a fair and rational measure of ability to pay for postsecondary education. In general, need analysis procedures follow the definitions of the Internal Revenue Service. Adjusted gross income, an IRS concept, is the point of departure for determining family income. A clear advantage to this approach is the close correspondence between the definition used in need analysis and that used for tax purposes. The data can be obtained by families from their tax returns and, similarly, can be verified by the aid administrator using the same returns. Nevertheless, there are some limitations to the usefulness of adjusted gross income (AGI). The definition of AGI has been developed in order to administer the federal income tax code. This purpose is different from the aid administrator's goal in performing need analysis. Because of this, certain "adjustments to income" allowed for income tax purposes are not allowed for need analysis purposes.

Aid administrators should keep in mind that, for need analysis, income data are used to predict resources available for the academic year in question. It may be helpful to think of income in terms of annual income flow. This concept takes account of additional sources of family support that may be excluded from AGI because of current tax laws. By considering income in this way, the aid administrator may get a clearer picture of a family's financial circumstances -- particularly its discretionary income -- from year to year without the distortions that are inherent with the tax-related definition of adjusted gross income. Such an income definition might also disregard unusual variations in the pattern of annual income, such as capital gains, and might eliminate losses that do not necessarily represent a loss of income. Reasons for disengaging the definition of income from the tax system may be seen when there is a major change in the income tax code, as there was with the Tax Reform Act of 1986. The change in definition of adjusted gross income is substantial enough in some cases to alter significantly the calculation of total family contribution.

Base year versus estimated year data

The standard need analysis methodology assesses prior year income rather than income received during the year the student is enrolled. This income, however, may be subject to wide variation from year to year. A change in income may be attributable to unemployment, illness, or retirement. Income in some occupations, such as sales, farming, and small business, may fluctuate from year to year. If the base year income is viewed as predictive of the family's ongoing situation, it should remain the basis for need analysis. If it is not, it may be appropriate to recalculate the family contribution on the basis of projected income for the estimated year. In some instances adjustments may be made in the middle of the academic year when information for the "estimated" year is no longer estimated. It should be noted that for federal aid programs, estimated year income is used to calculate the contribution of a "dislocated worker."

There is an increasing awareness among aid administrators of the necessity of establishing procedures to assess (or reassess) the need of families whose situation is in flux, such as those who are recently widowed, newly divorced or separated, or those who have become displaced from work. Determining whether it is appropriate to base need calculations on the estimated year deserves careful consideration. If the need analysis is shifted to the estimated year, some aid administrators make adjustments for inflation in the standard maintenance allowance and in the adjusted available income brackets from which the parents' contribution is derived.

Sometimes families are pessimistic about extra income, such as sales bonuses or overtime work. Aid administrators usually will not make adjustments in advance for loss of such income unless it is documented by the parent's employer.

Families may have difficulty in furnishing information about their estimated year income, especially if the aid administrator's request for data is too open-ended. A common practice is to request actual earnings and untaxed income to date for the calendar year in question, with an estimated amount for the rest of the year. Of particular importance are income reductions related to documented job changes or unemployment. A review of assets, including ownership, may be considered for newly divorced or separated parents.

In a case with highly fluctuating yearly income, a three-year average may be a treatment worth considering, using copies of tax returns to document the average. An even longer term for averaging may be appropriate in exceptional cases. This procedures may also be followed in considering large one-time gains or losses.

Another area of concern may be an income reduction that does not meet some special condition requirement, but is regarded by the family as significant enough to preclude the student's further enrollment. [Note that the Special Condition Application will not exist after the 1987-88 award year.] Collecting additional information through conversation or communication with the family may help determine, with as much certainty as possible, the appropriateness of calculating the family contribution on data for the estimated year.

Examination of detail of total income

For an accurate assessment of more complex family financial situations, it may be necessary to examine the separate elements of total income. Sometimes families will provide a total income figure that is derived from more than one source. One line of the application may combine both parents' salaries, business or farm income, or rental income. Boarding school teachers, clergy, members of the military, and persons in similar occupations may omit "in kind" remuneration for housing, board, or transportation. The aid administrator may want to request additional information from such individuals and adjust their income to reflect more accurately the family's financial strength.

Wages, salaries, and tips

The occupation listed by the parents may provide some basis for assessing the appropriateness of income figures. The number of years on a particular job may indicate whether the family has had the opportunity to accumulate assets for education and other purposes.

It may be useful to compare the occupation listed on the financial aid application with that listed on the income tax returns, if they are collected. For instance, if the aid application

lists the occupation as "salesman," while the income tax return indicates "company president," the aid administrator will probably want to investigate the possibility of business ownership and business worth. Conversely, the occupation may suggest deductions which have been inadvertently omitted by the parents.

The parent's occupation may also alert the aid administrator to changes that may be about to occur. For example, if a parent is employed by a company that has financial problems or has recently laid off employees, this information may prompt an inquiry about the parent's ongoing job security. If there is a loss of employment, further documentation would be necessary, but the original information may help confirm the situation that ultimately developed.

Interest and dividend income

Interest and dividend income is directly tied to the family's statement of the value of their cash, savings and checking accounts, stocks, bonds, and other investments. In cases in which sizable investments are indicated without reasonable interest or dividend income shown, the aid administrator may choose to calculate a reasonable yield on the investments and add it to income. The current interest rate on passbook savings will provide a conservative estimate of yield. The imputed value should be compared with interest and dividend income reported on the family's income tax return and adjusted, if necessary. The imputation of reasonable return on an investment is not always appropriate. For example, United States savings bonds, owner-financed mortgages, and installment sale agreements are examples of assets that yield interest income which may not accurately reflect the value of the assets. It should also be noted that interest and dividend income from tax-exempt investments may be included in untaxed income and not adjusted gross income.

Net income (or loss) from business or farm

Only limited information about a family's business or farm is included in standard need analysis documents. Any detailed examination of income from a business or farm will require additional information from the family. This may be obtained through need analysis supplements completed by the family, profit and loss statements, or copies of the relevant income tax returns for the business or farm. Income tax forms may include:

- Form 1040, Schedule C -- profit or loss from a business or profession
- Form 1040, Schedule E -- supplemental income (rents, royalties, pensions, annuities, partnerships, small business corporations, estates, and trusts)
- Form 1040, Schedule F -- farm income and expense
- Form 1065 -- partnership return of income
- Form 1065, Schedule K-1 -- partner's share of income, etc.
- Form 1120 -- corporation income tax
- Form 1120A -- corporation income tax (short form)
- Form 1120S -- small business corporation income tax

- Form 1120S, Schedule K-1 -- shareholder's share of undistributed taxable income (from a small business corporation)

Much information that is useful in evaluating a business may be obtained from its income tax returns. For need analysis purposes the aid administrator may want to examine general sources of income for the business in relation to its principal activity, operating expenses, and reported assets. Compensation of officers and the employment of other family members should be reviewed for consistency with the family income used in need analysis. A close examination of the enterprise's year-end cash position is recommended. Sometimes money will be carried over in the business cash account rather than being drawn as salaries or profits. In cases in which significant cash has accrued, the aid administrator may want to treat a portion of the cash as income for computation purposes rather than leaving it as a business asset.

In reviewing the balance sheets or profit and loss statements of a business corporation or partnership, the aid administrator should compare figures for the beginning and ending of the operating year. Significant changes may reflect fluctuations in business activity as well as financial interactions between the business and its owners. Of particular interest for need analysis purposes may be changes in assets, such as cash on hand and loans to stockholders, and in liabilities, such as mortgages, loans from stockholders, and retained earnings. For a partnership or closely held corporation, these changes may represent cash flow to (or at least possibly available to) or from the owners.

The operating expenses of a business or farm may also be reviewed by the aid administrator. Business deductions for car and truck expenses and for travel and entertainment sometimes raise questions about whether all such expenses should be allowed to reduce income in need analysis. If the business is operated at home, deductions for such expenses as rent on business property, utilities and telephones, and laundry and cleaning may also be questioned. If other family members are employed by the business, the cost of operations (including labor), and deductions for employee benefits programs and pension and profit-sharing plans should also be examined. For farm cases, deductions are generally more specific and more obviously farm-related. Even so, if other family members are employed on the farm, the aid administrator may want to review deductions for labor hired, pension and profit-sharing plans, and employee benefits programs.

Depreciation as an operating expense may present particular problems for the aid administrator. Capital expenditures, such as for buildings, motor vehicles, furnishings, equipment, and inventories, are subtracted as expenses over an extended period of time. The period for depreciation of assets is somewhat related to the expected useful life of the asset. The Internal Revenue Service has elaborate rules for determining the period over which these operating costs may be recovered, though generally the depreciation rules overstate the rate at which an asset's value declines. This is particularly the case with buildings and other real estate improvements, which typically appreciate in value over time.

Some aid administrators eliminate all depreciation as an allowance against business or farm income. This treatment may be too harsh, however, because depreciation is the only way a business or farm owner may recover the cost of a capital outlay. A more appropriate approach might be allowing a portion of depreciation as an expense in cases that involve farming, mining, manufacturing, or other activities in which equipment or motor vehicles are necessary and are subject to more frequent replacement.

If a business or farm is not the major source of income for a family, losses incurred may be legitimate for income tax purposes, but the aid administrator may not always choose to allow them for purposes of determining the expected family contribution toward educational expenses.

It should be noted that for federal aid programs, the definition of income excludes any proceeds from the sale of business or farm assets that may result from voluntary or involuntary foreclosure, forfeiture, or bankruptcy, or involuntary liquidation.

Rents, royalties, partnerships, estates, trusts, etc.

The net balance of these various kinds of income is included in adjusted gross income and reported on the IRS Form 1040. To examine income in these categories it usually is necessary to obtain a copy of the family's IRS Form 1040, Schedule E. In the past it was not unusual to find a loss resulting from this income. This will occur less frequently in 1987 and beyond. The Tax Reform Act of 1986 reduced the proportion of losses from passive income that may be included in adjusted gross income for tax years 1987 through 1990. Beyond 1990 no losses from passive income may be included in adjusted gross income. Passive income is derived from activities in which the taxpayer is not actively engaged, such as in rental property managed by others, limited partnerships, and so forth.

Rents. Gross income from rental property may be reduced by expenses included in operating and maintaining the property. These include taxes, mortgage interest, utilities, repairs, insurance, and so forth. Most aid administrators accept these expenses, although some will disallow travel expenses if the rents are derived from a vacation property, especially if management fees are allowed. Rental income from an owner-occupied multiple-family dwelling may also warrant closer examination of expenses. Some aid administrators question whether expenses for maintenance and repair would be any different if the dwelling were occupied only by the owner's family, and disallow such costs. It should be noted that although interest expenses are included in IRS Schedule E, the principal represented by mortgage payments on rental property is not included. The aid administrator may want to obtain the amount of this expense from the family so that the net rental income can be properly adjusted. Depreciation on rental property allowed for income tax purposes is regarded by some aid administrators as inappropriate for need analysis purposes. Allowing depreciation as an expense may understate actual cash flow from rental income. Another approach to the tax losses that frequently appear in rental property cases could be to impute income which represents a reasonable annual yield on the property, reduced by the amount of mortgage payments (both principal and interest).

Royalties. Royalties are generally derived from one of two sources -- either (1) from copyrights, patents, and trademarks, or (2) from payments for oil, gas, minerals, or timber extracted from property in which the recipient of the royalty holds an interest. Royalties usually do not produce losses, although in some instances government-approved depletion allowances will reduce royalty income in the second category noted above. Aid administrators usually do not permit depletion allowances to offset royalty income. In some cases depreciation may be claimed on a copyright or patent. Although this is seldom encountered, it may be appropriate to disallow such an offset of royalty income.

Partnerships. Partnership income is reported as a net figure on IRS Schedule E. More detail may be obtained from the partnership return (IRS Form 1065) or from the partner's record of income from the partnership (IRS Form 1065, Schedule K-1). If the partnership is not a major source of income, it may be held by the family as a tax shelter. This is especially true of

limited partnership investments, which typically produce sufficient losses to offset any income for tax purposes. These losses are usually derived from depreciation of major capital investments made by the general partners. Some aid administrators disallow such losses, and include any ordinary income or guaranteed payments reported on the partner's Schedule K-1.

Estates and trusts. Income from estates and trusts is the net amount derived from assets administered by a fiduciary, such as a bank or trust company. The income may come from interest and dividends, capital gains, real estate, businesses, farms, partnerships, and so forth. Some aid administrators inquire into the nature of the estate or trust to see whether the net distributions reported reflect all the income actually derived. The fiduciary must file a tax return (IRS Form 1041) for the estate or trust. The aid administrator may want to obtain a copy of this form, or at least a copy of the beneficiary's statement of income (IRS Form 1041, Schedule K-1). In addition, the aid administrator may review reported investments to be certain that the estate or trust has been included.

Small business corporations. Net income from small business corporations is also included in IRS Schedule E. A small business corporation is a firm with a limited number of stockholders who report the corporation's income on their individual income tax returns, according to their holdings in the business. The corporation's tax liability is also passed on to the stockholders. Sometimes new businesses are organized in this way. In recent years, however, many small business corporations have been organized to serve as tax shelters for the stockholders. Because of changes in the structure of taxation on individuals and corporations under the Tax Reform Act of 1986, there are increased incentives for businesses to be organized as "S" corporations. The aid administrator may want to collect supplemental information about the corporation, including a copy of the corporate tax return (IRS Form 1120S) or the shareholder's statement of income (IRS Form 1120S, Schedule K-1).

Capital gains (or losses)

The Tax Reform Act of 1986 eliminated the former distinction between short-term and long-term capital gains. For 1986 and earlier, a short-term gain was realized from the sale of an asset held for twelve months or less; a long-term gain, from assets held for more than twelve months. Short-term gains were fully taxable, whereas only a portion (40 percent) of long-term gains were taxable. (The time period and percentage had been changed from time to time by the federal government.) Beginning in 1987, all capital gains are fully taxable.

Capital losses, along with losses carried forward from previous tax years, are allowed to offset gains for income tax purposes. As much as $3,000 of a married couple's ordinary income may be offset by capital losses. For a single person or a married person filing a separate return, the maximum offset against ordinary income is $1,500.

There are special rules that pertain to the sale of a home. There is no capital gain for tax purposes if a new home is bought or built within two years of the sale of a former residence. In addition, if a taxpayer is age 55 or older, he or she may exclude as much as $125,000 from taxable income if married and filing a joint income tax return, or $62,500 if single or filing separately. The special exclusion may be opted for only once in a lifetime and applies only to a residence that has been owned and lived in by the taxpayer during at least three of the past five years. Losses from the sale of a principal residence are not allowed by the Internal Revenue Service, and therefore are not an element in adjusted gross income.

Capital gains pose a problem in assessing a family's ability to pay for postsecondary education. Because capital gains are a part of the federal definition of total income, they are treated the

same as other income in determining the family contribution under the Congressional Methodology. Although a capital gain reflects a real cash flow in the year for which it is reported, it nevertheless represents an asset in transition. Frequently the asset is converted almost immediately into another asset. For example, profit realized from the sale of stock must be reported as income in the form of capital gains even though the entire proceeds may have been invested in another enterprise. For this reason there is uncertainty among aid administrators about whether to treat capital gains as income or assets, or both.

Some aid administrators regard most capital gains not as income, but rather as assets. In many instances assets that have made some transition as capital gains are already reported in their new, transformed, and appreciated state. These administrators contend that it is appropriate for the Internal Revenue Service to consider capital gains, because it is only when appreciation is realized as a gain that the tax laws apply. For need analysis purposes, however, they assert that, because the present market value of assets is already considered, it is inappropriate to "double count" the appreciated value of an asset both as asset and as income. Among aid administrators who take this position, some have the practice of nullifying all capital gains when calculating family income. Others negate capital gains if it appears that they are a one-time occurrence, but include gains if they represent a recurring pattern of income. Another approach is to consider the number of years over which a capital gain has accrued. By dividing the gain by the number of years, the aid administrator can approximate the annual income flow represented by the gain. Capital losses are generally disallowed by aid administrators who omit capital gains from family income calculations, on the ground that a loss is reflected in the diminished present value of a family's assets.

Other taxable income

Other income that may be a part of adjusted gross income includes refunds from state and local income taxes, alimony received, taxable portions of pensions and annuities, unemployment compensation, and other taxable income. It may be necessary to review the family's income tax return and accompanying schedules to get a complete picture of these sources of income.

Refunds from state and local income taxes. These refunds are reported on the federal income tax return only if they come from a prior year in which state and local income taxes were taken as an itemized deduction. The Internal Revenue Service includes refunds in current income because in the prior year the refund was not taxed by virtue of being an itemized deduction. Refunds, however, do not represent new income for the family. Because of this, some aid administrators delete refunds from the family's total income. In addition, unless there is a significant change in the amount of state and local income taxes withheld from earnings, even a recurring pattern of refunds does not reflect a difference in income flow from year to year.

Alimony received. Alimony paid to a taxpayer by a former spouse is a part of adjusted gross income. If the noncustodial parent of a dependent student has provided information to the aid administrator, the custodial parent's alimony figure can be checked with the noncustodial parent's figure. The aid administrator may want to correspond with the parents to clarify any inconsistencies. Differences are sometimes related to each parent's understanding of the nature of the payments. It is frequently the case that the noncustodial parent considers payments made to a former spouse as alimony, which may be subtracted from total income as an IRS "adjustment to income." The receiving parent may regard the payments as child support, which is not subject to taxation as income.

Pensions and annuities. Income from pensions and annuities may be either taxable or untaxed. In general, if contributions to a pension plan were tax-sheltered in a retired person's employed years, the income from the pension will be taxable. Individual Retirement Accounts (IRAs) and Keogh plans are examples of such retirement provisions. If a retired employee contributed to a company's pension plan during his or her working years, the pension benefits are untaxed until the retiree has received benefits equal to his or her contribution. Benefits received in excess of the employee's contribution level are taxable. The untaxed portion of annuity income is related to the ratio of the annuitant's investment to the prospective return on investment. In general, "rollovers" that are reported on the IRS Form 1040 represent conversion of retirement assets from one form to another, and do not represent income flow. There usually is no question that pension and annuity income should be included in income for need analysis; the question instead is whether all such income has been revealed. The aid administrator may want to inquire whether all retirement income has been included in the need analysis document if it appears that a family's living costs consume an inordinate part of the family's reported resources.

Unemployment compensation. In 1986 and earlier, unemployment compensation may have been included in adjusted gross income. In general, if a family's other income was under $18,000, any unemployment benefits were untaxed. (The ceiling was $12,000 for single persons and individuals who file separate tax returns.) If other income exceeded that level, a portion of unemployment benefits were taxable. The Tax Reform Act of 1986 made all unemployment compensation taxable beginning with the 1987 tax year.

If there is no indication when or whether unemployment might end, the aid administrator may want to correspond with the family about its situation and any prospect for new employment. In some instances the aid administrator may want to flag the student's file for review later in the academic year to see if the family's circumstances have changed.

Other taxable income. The final item in the income section of the IRS Form 1040 is a catchall category for miscellaneous other income. This may include honorariums, gambling and lottery winnings, other prizes or awards, and recovered bad debts. Net operating losses, formerly included in this category, have been eliminated as of 1987 by the Tax Reform Act of 1986. Some aid administrators do not consider miscellaneous income to be recurring and, therefore, exclude it from income. Others include the income despite its "windfall" character.

Untaxed income and benefits

Untaxed income and benefits include social security benefits, Aid to Families with Dependent Children (AFDC), and other untaxed income. "Other untaxed income" is sometimes a troublesome item because the family is asked to list aggregate benefits for the entire household. It may be difficult to identify those benefits that go directly to the student and separate them from support provided for other family members. Some income in this category may be unreliable because of changes in the level of support or changes in the number of family members supported.

It is sometimes difficult to obtain complete information about benefits received and the current rules governing the various programs. The aid administrator should maintain close contact with students who receive such benefits. It may also be helpful to establish communications with principal public welfare agencies and arrange to be notified about changes in benefit levels and regulations related to eligibility.

Social security benefits. Social security benefits may be paid to an individual who is retired or disabled, or to a parent who is a surviving widow or widower who has dependent children who are under age 18 or who are physically or mentally handicapped. The aid administrator may want to review the aid application to see if either parent is retired or disabled. If a parent is widowed, this may be indicated in the need analysis form; however, if the surviving parent has remarried this is not always readily apparent. If there is a stepparent present and it appears not to be a divorced or separated case, it may be appropriate to inquire if social security benefits are received by the family.

Aid to Families with Dependent Children. If AFDC benefits are reported by the family, the aid administrator may want to review the aid application to see if benefits will continue in the academic year. If the benefits will be discontinued, an adjustment in the need analysis may be indicated.

Other untaxed income and benefits. The instructions in need analysis forms include a list of income items that may be reported as other untaxed income and benefits. Some forms of income have both taxable and untaxed components. These include:

- Interest and dividends -- interest from tax-exempt securities. (Dividend exclusions and dividend reinvestment exclusions have been eliminated for 1987 and beyond by the Tax Reform Act of 1986.)
- Capital gains -- untaxed portions of long-term gains for 1986. (Capital gains are fully taxable in 1987 and beyond.)
- Pensions and annuities -- untaxed portions
- Unemployment compensation -- untaxed portion for 1986. (Unemployment compensation is fully taxable in 1987 and beyond.)

Other benefits that are not reported elsewhere are also included. For example:

- Railroad retirement benefits
- Workmen's compensation
- Veteran's benefits
- Disability income
- CETA noneducational benefits

Three additional forms of untaxed income merit special attention. These are child support received, foreign income exclusions, and untaxed income in kind.

Child support. Child support may be paid by a noncustodial parent to a custodial parent to help maintain the children of the dissolved marriage. If the parents' marital status is single, separated, or divorced, it may be that child support is received. If no support is reported, the aid administrator may want to investigate whether child support payments have been omitted from the need analysis documents. Some aid administrators require evidence that child support has been sought but is not forthcoming. In some states, public welfare agencies can provide replacement support payments, although this may sometimes occur only on order

of a court. If additional information is obtained from the noncustodial parent, the figures reported for child support may be compared with the figures used in need analysis. The aid administrator should attempt to reconcile any discrepancies in the figures. As noted in the earlier discussion of alimony, there may be some confusion over the designation of payments made by one parent to another.

Foreign income exclusions. Foreign income exclusions are not frequently encountered, but they may be substantial. The Internal Revenue Service allows Americans residing abroad to make deductions from income for cost-of-living differences (except for federal government employees), schooling expenses, transportation expenses for home leave, as much as $5,000 for working in a "hardship area" designated by the United States Department of State, and housing expenses for a principal place of residence (and in some cases, a second). In some instances workers in "hardship area" camps with substandard lodging may exclude as much as $20,000 from their income for federal tax purposes. Aid administrators may want to obtain IRS Form 2555, "Deduction from, or Exclusion of, Income Earned Abroad," to see whether deductions have been made from the income reported in the need analysis form.

Untaxed income in kind. In cases in which nonmonetary, in-kind support is provided to a family, the aid administrator may be justified in estimating the value of the housing, food, or other services. Military personnel, clergy, and faculty members may receive housing allowances or subsidies. Military personnel receive quarters allowances that vary by rank. The use of a percentage of salary as a means of estimating the value of housing may be helpful in the case of clergy and faculty. The provision of housing allowances for clergy has been changing. Aid administrators may find it helpful to contact area denominational offices for help in developing reasonable guidelines. Faculty members who pay rents of less than 5 percent of the appraised value of their housing have taxable income equal to the difference, according to the Tax Reform Act of 1986. If the faculty member lives in the housing as a condition of employment, however, it is nontaxable.

Allowances against income

After the aid administrator is satisfied that the family's total income has been properly determined, the allowances against income should be reviewed.

U.S. income tax paid

The amount of U.S. income tax paid can provide a crosscheck for taxable income. In cases in which the U.S. income tax paid is significantly higher or lower than the standard tax, the aid administrator may want to ask for more detailed income and tax figures or request a copy of the income tax return with appropriate supplements. These materials may explain the unusual situation and document its legitimacy of the variance from the standard calculation.

Sometimes families report the tax withheld (as recorded on W-2 forms) on the need analysis document instead of the actual tax paid. In other instances, they may include miscellaneous taxes, such as FICA tax for self-employment. A discrepancy may also arise from errors made because the family did not read the instructions carefully or because the application was completed before the income tax return was completed.

In cases that require a recalculation of the income tax figure it is not necessary to use a standard tax amount if it is clear that the family has a significantly greater tax liability than the standard. The most recent figure for tax paid can be used as an indicator of the proportion of income that will be paid as taxes. This procedure is especially appropriate for

families with substantial itemized deductions or IRS adjustments to income. Follow-up verification of actual tax paid is always preferable to using a projected tax figure.

Care should be taken in reviewing the applications of American nationals living abroad. The need analysis services may provide a standard calculated tax that may be larger than the amount actually paid. In such cases the aid administrator may inquire about taxes paid to a foreign country and use that figure in lieu of the U.S. income tax.

State and other taxes

The allowance for state and other taxes is based on the family's total income and state of residence. In some cases employment may be in a metropolitan area that imposes local income taxes or employment may carry family members across state boundaries. In such cases, the student's family may be subject to more than one state or local tax, and adjustments may be appropriate. The state and other income taxes figure may be reported on IRS Form 1040, Schedule A. It should be noted, however, that the Tax Reform Act of 1986 has excluded all other state and local taxes from itemized deductions beginning with the 1987 tax year.

FICA taxes

Standard need analysis procedures based the FICA tax calculation on the earnings of each parent, using the tax rate applicable to persons employed by others. Some aid administrators adjust the FICA tax amount in applicable cases to accommodate the higher rate that applies to self-employed persons. For the 1986 base year, the rate is 12.3 percent of the first $42,000 of self-employment income, or a maximum of $5,166.

The FICA tax rates may be adjusted from time to time. The rate for self-employed persons in 1987 is 12.3 percent of the first $43,800 of income, or a maximum of $5,387. The rate for employed persons in 1987 is 7.15 percent of the first $43,800 of income, or a maximum of $3,132. The rate for employed persons is scheduled to be 7.51 percent in 1988 and 1989, and 7.65 percent in 1990 and beyond. The wage base is adjusted periodically for increases in average wage levels.

Until January 1, 1984, federal employees did not pay the FICA tax, but were subject instead to a comparable federal retirement tax. Changes in the social security law now require the payment of FICA by federal employees.

Medical and dental expenses

An allowance is made in need analysis for medical and dental expenses that exceed 3 percent of the family's total income. The aid administrator should be alert to the possibility that expenses for medical or dental treatment are reported but the insurance reimbursement has been omitted. Attention should also be paid to medical insurance premiums which are partially excluded from itemized deductions by the IRS, but which represent legitimate allowances for need analysis purposes.

Only the annual costs of longer range medical and dental care, such as psychiatric expense, cancer therapy, or orthodontic work, should be reported. Extremely large or accumulated expenses should be carefully reviewed for appropriateness. One possible treatment of large indebtedness for medical and dental bills is to consider the indebtedness as an allowance

against assets. In some instances, this more clearly approximates the family's actual cash flow because they may not be able to repay the medical debt during the one year upon which the application is based.

Unreimbursed elementary and secondary school expenses

For the 1987-88 academic year, the standard need analysis methodology provides an allowance for elementary and secondary school expenses that exceed percent of total income, up to a maximum of $3,150 for each dependent child. The allowance ceiling is revised annually according to the national average per pupil cost of public elementary and secondary instruction.

There is a wide range of opinion about whether this allowance is appropriate. What is at issue for some aid administrators is whether the family has exercised discretion in incurring expenses that reduce their available resources. In general, discretionary decisions that reduce the expected family contribution are treated differently from expenses incurred about which the family has no choice.

The family's decision, particularly when a religious school is involved, may be the factor that determines whether the allowance is permitted. Other considerations may be whether the child is required to attend a particular elementary or secondary school for medical, emotional, physical, or perhaps even academic program reasons. In any of these cases it may be appropriate to grant an allowance for elementary or secondary tuition expenses. On the other hand, when awarding limited funds to needy students, the financial aid administrator may elect to reduce or eliminate the allowance if attendance at a particular school is one purely of individual choice.

Extreme care should be exercised in establishing an institutional policy concerning the elementary and secondary expenses allowance. Such a policy should reflect the institution's philosophy and should be consistently applied.

Employment allowance

The employment allowance is based on 35 percent of the lower income from employment in a two-parent family or the only income in a one-parent family, to a maximum of $2,100. If a parent is employed in the home, some aid administrators will reduce or eliminate the allowance. They justify their action by noting that the allowance presumes employment outside of the home. Yet other aid administrators reduce the allowance if a parent is employed only part-time. The assumption that part-time employment necessarily implies partial employment costs, however, may not always be correct.

Some parents have additional employment costs that are not reflected (or at least not fully reflected) in the employment allowance. These costs may include child care, union dues, uniforms and other work clothes, tools, and so forth. In addition, some employees have business expenses for travel, food, and lodging that are not reimbursed by their employers, and which are not deductible for income tax purposes because of changes made by the Tax Reform Act of 1986.

Standard maintenance allowance

The standard maintenance allowance is based on the family size and number of family members in college. If either of these figures has been changed, the standard maintenance allowance should be adjusted.

The allowance figures are derived from national data about the cost of living that are reflected in the Bureau of Labor Statistics lower budget standard. The financial aid administrator may want to adjust the allowance for cost-of-living differences in various parts of the United States. The Bureau of Labor Statistics annually publishes updates of its indexes of living costs for major metropolitan areas and various regions of the country.

Other allowances

Establishing a list of generally allowable additional expenses can simplify the task of processing applications. A key element that should be considered in evaluating potential allowances is whether they are voluntary or involuntary. Clearly, nondiscretionary expenses incurred by the family should be allowed. Examples include child support payments, funeral expenses, legal fees, moving expenses, and unreimbursed employee business expenses. (The latter two items were IRS "adjustments to income" in 1986 and earlier; in 1987 and following they are IRS itemized deductions.) Optional expenditures, on the other hand, may require a judgment by the aid administrator as to whether such expenditures should take priority over postsecondary education in the family's budget.

Adjustments to income

The Internal Revenue Service allows several kinds of expenses to be excluded from taxable income as "adjustments to income." These include unreimbursed moving expenses, unreimbursed employee business expenses, contributions to IRA and Keogh retirement plans, penalties for early withdrawal of funds from time savings accounts, alimony paid, and a deduction of a portion of the lower income of a married couple if both work. The Tax Reform Act of 1986 eliminated the "married couple" deduction as of 1987. The Act has also reclassified moving expenses and unreimbursed employee business expenses as itemized deductions. The deduction for business expenses is limited to the amount in excess of 2 percent of adjusted gross income. As of 1987, IRA payments may be fully subtracted as adjustments to income by taxpayers with gross incomes of less than $25,000 (or $40,000 for joint returns). A portion of IRA payments may be subtracted by taxpayers with incomes less than $30,000 (or $50,000 for joint returns).

Standard need analysis procedures for 1987-88 call for IRA and Keogh payments and the "married couple" deduction to be added back to total income. Payments to IRA and Keogh plans are regarded as voluntary, or discretionary, expenditures for many families and, therefore, are included in total income for need analysis purposes. The need analysis provisions of the Higher Education Act exclude IRA and Keogh payments from income for academic years 1988-89 and beyond. The "married couple" deduction was a provision to help equalize tax burdens but did not represent income flow. It also was included in total income.

Depending on the individual family's circumstances, the financial aid administrator may wish to consider modifying the treatment of payments to IRA/Keogh programs in determining the family contribution. One alternative is to include the IRA/Keogh payments as assets rather than as income, thereby allowing these payments to be protected for retirement purposes like

other assets. Another approach the financial aid administrator may consider depends on whether there is another, employer-sponsored retirement plan. If no other retirement program is available, the financial aid administrator may consider allowing the IRA/Keogh payments as adjustments to family income.

Available income

The family's available income is calculated by subtracting the total allowances from total income. The remainder, if any, is presumed to be available for discretionary and supplemental spending (including postsecondary education) beyond the minimum level of support provided by the standard maintenance allowance, which is based on the Bureau of Labor Standards lower budget standard.

Parents' assets

In reviewing a family's assets, the aid administrator should keep in mind that it is logical to expect that assets are held by a family for some economic advantage. Assets should appreciate in value, produce income, or provide a benefit, such as shelter or a tax advantage. In many instances they do all of these. For this reason assets should be examined with an eye to their interrelationship with income or to the benefits derived from them.

For federal purposes, any home equity is omitted from need analysis for "dislocated workers" and "displaced homemakers." In addition, some categories of assets may be excluded altogether for certain Native Alaskans and American Indians.

Cash, savings, and checking accounts

The aid administrator may want to compare the amount reported for cash, savings, and checking accounts with interest income reported on income tax returns. If the yield rate does not seem reasonable, some aid administrators impute a value using the interest figure as the basis for the calculation. Others consult the family to reconcile the apparent discrepancy. If an inordinately large amount of cash is reported, the aid administrator may want to ascertain whether any major outlays are expected in the near future. For renewal cases, this item serves as an excellent barometer of the family's cash flow and life style while paying for education. Severe fluctuations from year to year may indicate either excessive harshness or generosity in the previous need analysis and adjustments may be considered.

Home equity

Home equity is calculated from the figures reported for present market value and outstanding mortgage. Some aid administrators have the practice of using the purchase price of home and its year of purchase to check the family's figures against a national table of real estate appreciation. It should be noted that home values may be affected by a number of factors that are not reflected in national tables. Depressed housing markets in particular parts of the country, neighborhood deterioration, and industrial or highway encroachment are some reasons for slower appreciation or even a reduction in value. In addition, mobile homes generally depreciate in value in the same way that motor vehicles do.

Some aid administrators are especially concerned about the role that home equity plays in the expected family contribution. Some will reduce the family contribution in cases in which they believe home equity (or other illiquid assets) has too great an impact on the expected contribution. The justification for such adjustments is the reasonableness of the calculated

contribution in the professional judgment of the aid administrator. Others contend that, because of the substantial benefits realized from owner-occupied housing and the availability of loans based on appreciated home equities, it is inappropriate to discount the expected family contribution because of home equity.

In divorced or separated situations, the aid administrator should be certain that the parent filing the application has properly shown his or her percentage of ownership under present market value. If a separation agreement or final divorce decree is pending, and the home or other assets have not yet been divided, it may be appropriate to assume an even division until final action has been taken.

Other real estate equity

The possession of other real estate usually means that some income may be expected from it. This is not always the case, as in the case of undeveloped land or a second or vacation home that is not rented out. If income is produced, however, it should be included in adjusted gross income. If more information is needed, it should be requested from the family.

Some aid administrators impute an income from other real estate using a factor similar to the rate of return on other investments. Their position is that it is reasonable to assume that property held for investment purposes should be as economically productive -- in terms of income and appreciation -- as other forms of investment.

The purchase price and year of purchase of other real estate may be used to assess whether the reported value shows reasonable appreciation. An appreciation table for commercial properties is published annually by the United States Department of Commerce.

It should be noted, however, that because of economic conditions in a particular locale or region, real estate values may in fact decline. In such a situation it may be economically infeasible for a family to dispose of a property (even if they wanted to do so) without realizing a substantial loss.

Investments

Investments may be compared with dividend income to see if a reasonable yield is reported. If there is an apparent discrepancy, some aid administrators may impute a reasonable return on investments. Others may correspond with the family to resolve the matter. Aid administrators should be aware that there may be wide fluctuations in the value of investments and the return on them. In some cases the aid administrator may want to adjust the asset conversion rate to prevent a kind of "double taxation." This is especially the case if the standard analysis derives all or a large portion of the family income -- and thus the family contribution -- from investment income. This may be of particular concern for cases involving widowed parents.

In some instances investment income may be reported without a clear indication of its source. This may indicate income from a trust, estate, or insurance policy. The family may not have unlimited access to the corpus of trust or the assets of an estate. The aid administrator should determine the beneficiaries in these cases and the degree of flexibility or inviolability of the assets. This information may be used in the discretionary treatment of other assets or in the amount and kind of financial aid ultimately offered to the student. If the aid administrator believes that the family has neglected to report all of its income-producing

assets, clarification should be sought from the family. Special consideration may be needed in cases in which there has been a recent death because it may be too early to obtain a full evaluation of assets.

Business and farm

Business and farm assets may require careful review by the aid administrator. In the earlier discussion of business and farm income, it was noted that financial dealings of the business or farm, including transactions with the owners or others, may affect the assets of the enterprise. For example, net profit from a business or farm may be transferred to assets as cash on hand or retained earnings. The schedule of depreciation allowed for income tax purposes may be helpful in confirming the values of some business or farm assets. It should be remembered, however, that land may not be depreciated and that fully depreciated assets will not appear on depreciation schedules.

In some instances, the worth of a business or farm may have decreased. If the productivity of the land or business has declined over time or some external factor has made the business or farm less desirable, it would be reasonable to adjust downward the worth of the farm or business. Partnerships or corporations in which there is only a small share of ownership may create similar problems because the family cannot control business or farm activities. Sometimes a family cannot dispose of an asset because of the restrictions of a trust or complications arising from an estate.

Consumer and educational indebtedness

Although consumer debt and personal possessions are not taken into account in need analysis, it is possible to use this information if the family is heavily in debt but making strides to overcome the situation. Debts should be thoroughly reviewed for appropriate justification. The aid administrator should be aware of how the indebtedness is distributed among creditors and may disallow indebtedness for discretionary purchases, such as automobiles, boats, recreational vehicles, and so forth. Some families will show large indebtedness because of previous loss of income from extended unemployment, illness, or business failure. Special consideration may be given in such cases. Educational debts of the parents for their own education and current year payments required for other educational obligations (e.g., PLUS loans) may also be included at the aid administrator's discretion.

Income supplement from assets

The role that assets play in the total family contribution should be a reasonable one. By evaluating the relationship between asset strength and current income, the aid administrator can identify situations in which the expected contribution is not feasible. It may be necessary to adjust the asset protection allowance or asset conversion rate in cases involving retired parents, a widow or widower, or a parent with a terminal or debilitating illness. On the other hand, the aid administrator may wish to disallow a negative income supplement, especially when there is a history of relatively high income and an absence of assets.

Parents' contribution for the student

If adjustments are made in the family's income, allowances, or assets, it is necessary to recompute the parents' contribution for the student based on the revised adjusted available income and the number of family members in college.

In the earlier section on number of family members in college, procedures for reviewing the number were discussed. Once the number in college is determined, the standard procedure is to allot an equal portion of the total parents' contribution to each family member in college. This procedure, however, does not differentiate between higher and lower cost institutions. An alternate approach recognizing the difference is for the aid administrator to distribute the total parents' contribution according to the cost of education at each of the family members' colleges. For example, if the total parents' contribution is $8,000 and two children attend colleges costing $3,000 and $12,000 respectively, the calculated parents' contribution would $4,000 for each student. Some aid administrators, however, deem the parents' contribution to be limited to $3,000 at the lower-cost college, and hold that the "excess" $1,000 in contribution could be used by the other child. The parents' contribution, therefore, would be $5,000 at the higher-cost college.

Another alternative is for the aid administrator to divide the parents' contribution proportionately, based on the comparative costs of the institutions attended. Using the previous example, 80 percent (that is, $12,000 divided by [$3,000 plus $12,000]) of the parents' contribution would be applied to the expenses of the child enrolled at the higher-cost college and the remaining 20 percent to the sibling's expenses at the lower-cost institution.

It is left to the aid administrator to decide whether to follow the standard need analysis procedure or to make adjustments for disparate cost institutions. Consultation between aid administrators at the institutions involved would be helpful in such cases.

Dependent student's income and assets

For single dependent students the standard need analysis procedures should apply in most cases. Professional judgment is exercised primarily in determining whether all resources have been reported and in the appropriateness of the information. Contributions are expected from the student's income (summer savings or minimum self-help contribution, and untaxed income and benefits) and assets.

Contribution from income

The need analysis procedures for 1987-88 include a summer savings expectation as part of the total family contribution. For 1988-89 and beyond, the Higher Education Act specifies a minimum (or "mandatory") self-help contribution of the greater of either (a) $700 for freshmen or $900 for other students, or (b) 70 percent of the student's after-tax income for the calendar year preceding the academic year.

The aid administrator may want to review the student's income contribution figure to see if it is realistic. A student may not have the expected contribution because of illness, family needs, academic pursuits that precluded work, or the inability to find employment. If the student does not have the contribution, the aid administrator may adjust the expected figure to reflect the student's actual circumstances.

There are two views among aid administrators about summer earnings in excess of the institution's standard expectation. One view would allow the student to retain excess earnings without modifying the need analysis or aid package. The other view requires at least the minimum institutional expectation but would use the additional earnings as a resource in the analysis. Whichever approach is adopted, it should be applied consistently so that all applicants receive equitable treatment. If the additional summer earnings are counted as a

resource, it should be remembered that it is a form of self-help, and that the subsequent reduction in aid eligibility perhaps should come from either loans or employment in the package.

Contribution from student's assets

If substantial assets are reported by the student, some aid administrators will inquire about the nature of the assets before they make any decisions about the student's contribution from assets.

A student's assets held in trust can be viewed in various ways, depending on the terms of the trust. If the trust cannot be invaded for educational purposes, it may be appropriate to reduce the contribution and use a correspondingly higher proportion of self-help aid (loan or work) in the aid package.

Student assets which are the product of parental savings may, at the discretion of the aid administrator, be moved to parental assets, thus providing a larger measure of protection for those assets in recognition of their source. For example, assets may have been placed in the student's name by his or her parents under the Uniform Gift to Minors Act in order to take advantage of reduced income taxes on unearned income produced by the assets. Some aid administrators will regard all of these assets as a parental resource; others will "cap" the assets at an arbitrary level (such as $5,000) and assign the remaining assets to the parents in need analysis. If the student has siblings, some aid administrators ask the parents whether similar family assets are held by the student's brothers and sisters as well.

Independent students

Structure of need analysis

The 1986 amendments to the Higher Education Act significantly altered the structure of need analysis for independent students. For independent students without dependents, the contribution from income parallels the previous standard procedures with the following exceptions:

- Base year income (income for the calendar year preceding the academic year) is used in the calculation of total family contribution. (However, in the instance of a "dislocated worker," the calculation is based on "estimated" calendar year income.)

- The student expense budget is limited to the student's own educational and living costs for the period of enrollment.

- A maintenance allowance of $600 a month is granted in need analysis for periods of nonenrollment.

For independent students with dependents (including a spouse), the family contribution is calculated in the same way that the parents' contribution for dependent students is calculated, with the following exceptions:

- There is a minimum ("mandatory") available income of $700 for first-time undergraduates or $900 for other students.

- Student's veteran's benefits for the period of attendance are added to the student's available income and income supplement from assets to produce the adjusted available income figure from which the total family contribution is derived.

Marginal assessment rates on taxable income

The Congressional Methodology for independent students without dependents applies a marginal assessment rate to the student's available taxable income. Allowances are made for U.S. income taxes, state income taxes, FICA taxes, and maintenance costs during periods of nonenrollment. The student's contribution from income includes a contribution from available taxable income, untaxed income and benefits, and veteran's benefits for the period of attendance. There is a minimum ("mandatory") contribution of $1,200.

The marginal assessment rate applied to available taxable income, which permits a student to increase his or her standard of living as more income is earned, has budget construction implications. Institutions should use budgets that represent "minimum costs" for the student. Additional expenses, which supplement the basic budget, may be covered by the portion of the student's earnings that are not assessed by the need analysis methodology. In this way the marginal assessment rates on available taxable income provide an incentive for the student to seek employment. As the student's earnings increase, part of the increase if available to bolster the his or her standard of living.

Minimum contribution from taxable income

If a minimum contribution from taxable income (MCTI) is expected from the student (and spouse), the aid administrator may exercise professional judgment in altering the expectation. Reasons for doing this may include the following:

- Local economic and employment conditions;
- Medical reasons that preclude the student (or spouse) from being employed;
- Disability of the student (or spouse) that may limit or restrict earnings; and/or
- Any factor that may limit or impede the student's earning potential.

The aid administrator should carefully review the individual circumstances to determine if a lower minimum contribution is reasonable because of factors that are beyond the control of the student.

Estimated income versus previous income levels

Prior to the Congressional Methodology, calculation of the student's contribution from income was based on estimated resources for the academic year and preceding summer. The aid administrator may want to compare estimated income with the base year income reported on the need analysis form. It may be appropriate to adjust the expected contribution because of a student's prospective change of status from full-time worker to student and part-time worker. It may be necessary to collect relevant information about the estimated year, such as projected average weekly hours of work, rate of pay, tips (if occupation warrants), and periods of unemployment. Pay stubs, W-2 forms, and employer contracts are useful for subsequent verification of the projections. Work-Study and other forms of aid should not be included in student's or spouse's income.

Student's untaxed income and benefits

In reviewing untaxed income and benefits, the aid administrator should check to be certain that all sources of income are reported. It may be appropriate to request documentation from the relevant agencies in order to confirm the benefit levels. In some instances a student may have benefits that may not have been reported as income, such as food stamps, Medicaid, or housing benefits. In some instances regulations governing such benefits may specifically prohibit their inclusion as a student resource (e.g., food stamps) for need analysis purposes. Often professional judgment must be exercised in the need analysis, budget construction, and subsequent packaging of aid.

Student's and spouse's assets

The asset treatment for independent students employs different asset assessment rates depending on whether the student has no dependents, or has dependents (including a spouse). Independent students with dependents have their assets assessed in the same way that assets of the parents of dependent students are assessed, except that a negative income supplement is set equal to zero. For independent students without dependents, a 35 percent asset taxation rate applies.

For federal purposes, any home equity is omitted from need analysis for "dislocated workers" and "displaced homemakers." In addition, some categories of assets may be excluded altogether for certain Native Alaskans and American Indians.

If a contribution from assets is expected from the student (and spouse), the aid administrator may exercise professional judgment to alter the expectation in individual cases. Factors to consider include the following:

- The presence of dependent children;
- The liquidity of the family's assets;
- Catastrophic occurrences (e.g., terminal illness); and/or
- Substantial decrease in the net worth of any asset since the time the application was filed.

Children of divorced or separated parents

Given the increase in the number of students with divorced or separated parents, aid administrators must give careful consideration to establishing a policy that ensures equitable and consistent treatment of all students. In most instances, these situations require a particular sensitivity to individual circumstances. In many cases, it may be necessary to collect additional information from some or all parties in order to build a satisfactory analysis and subsequent financial aid package.

Reviewing a divorced or separated case

Some points to consider in reviewing a divorced or separated case are:

- The responsibility of both natural parents to contribute to their children's education, regardless of marital status;
- The measurement of ability to pay based on parental responsibility, rather than willingness;
- Whether parental responsibility should be limited by a legal agreement that has been executed;
- The length of time since a divorce or separation;
- The responsibility of stepparents, including consideration of any prenuptial agreement; and/or
- Guardianship as an indicator of economic responsibility for the student.

Calculating the family contribution

After assembling all necessary information (or an explanation for nonresponses to requests for information), the financial aid administrator should decide whether it is appropriate to expect a parents' contribution from both the custodial parent and stepparent. If this is the case, the usual need analysis procedures are followed. There should be no contribution expected from

the noncustodial parent beyond what may be paid in child support. On the other hand, if the aid administrator believes that it is appropriate to expect a parents' contribution from both the custodial and noncustodial parents, the situation is more complex. In general, separate analyses should be performed on each family unit, taking into account the family situation in each instance. Each resulting parents' contribution can be apportioned according to the parents' respective shares of their new family's resources. Each parent's separate share can be divided among any children in college. If the custodial parent is not employed and does not have substantial assets, the aid administrator must judge whether any contribution can be expected. If the stepparent's income places the family at a moderate standard of living, a contribution at least equal to basic maintenance can be expected. If the family's income is larger, somewhat more can be expected as a contribution.

Alimony and child support

The Internal Revenue Service treats alimony as income for the receiving parent and as an adjustment to income for the providing parent. Child support received is not considered taxable income for IRS purposes, and neither is it allowed as a tax deduction for the providing parent.

Instead of treating child support as untaxed income for the receiving parent, 75 percent of the child support may be applied as a direct resource for the applicant for a nine-month budget. The amount of child support is not necessarily a ceiling on the contribution from either parent. As suggested earlier, in the case of divorced or separated parents, there may be additional support being provided (or at least available) from the noncustodial parent beyond any alimony or child support payments required by a court decree.

Conclusion

This monograph outlines numerous circumstances in which the aid administrator may be called upon to exercise professional judgment. The financial aid administrator is expected to provide leadership in the development of institutional policies and guidelines for exercising professional judgment and to ensure the consistent application of those policies. When questions arise involving professional judgment, the financial aid administrator may find it helpful to consult colleagues at similar institutions. A continuing dialogue among financial aid administrators will prove beneficial in refining professional judgment, with the objective of serving students more equitably and compassionately.

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